Current Liabilities and Payroll Accounting

Chapter 11

Wild and Shaw

Fundamental Accounting Principles

25th Edition

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Chapter 11 Learning Objectives

CONCEPTUAL

C1 Describe current and long-term liabilities and their characteristics.

C2 Identify and describe known current liabilities.

C3 Explain how to account for contingent liabilities.

ANALYTICAL

A1 Compute the times interest earned ratio and use it to analyze liabilities.

PROCEDURAL

P1 Prepare entries to account for short-term notes payable.

P2 Compute and record *employee* payroll deductions and liabilities.

P3 Compute and record *employer* payroll expenses and liabilities.

P4 Account for estimated liabilities, including warranties and bonuses.

P5 *Appendix 11A* – Identify and describe the details of payroll reports, records, and procedures.

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Learning Objective C1

Describe current and long-term liabilities and their characteristics.

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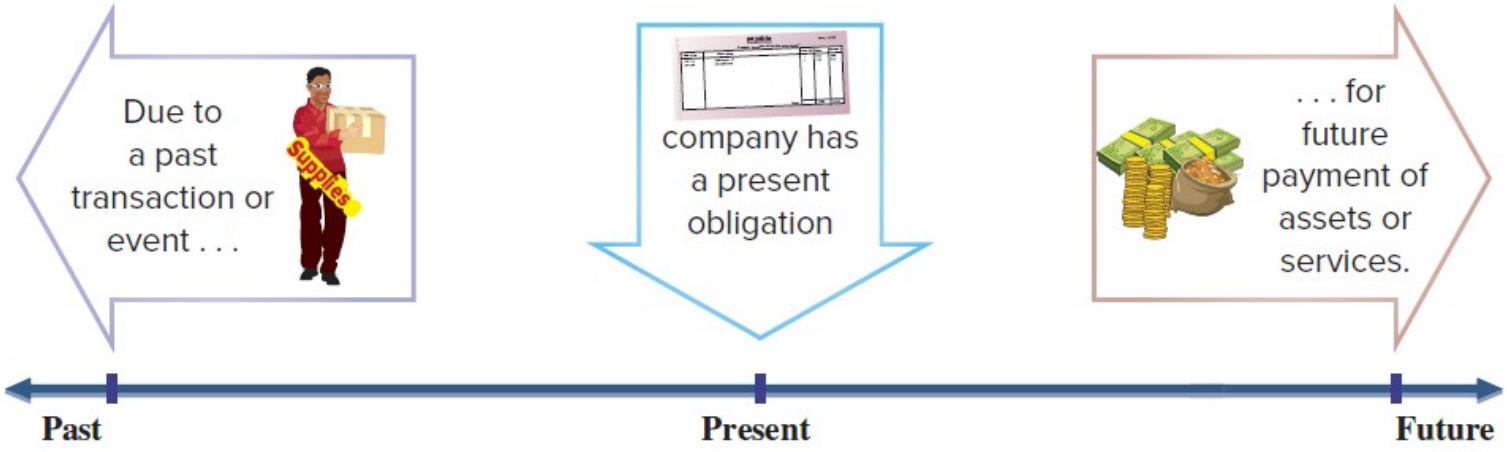
Defining Liabilities

Exhibit 11.1


Due to a past transaction or event . . .
Supplies
company has a present obligation
. . . for future payment of assets or services.
Past
Present
Future

Learning Objective C1: Describe current and long-term liabilities and their characteristics.

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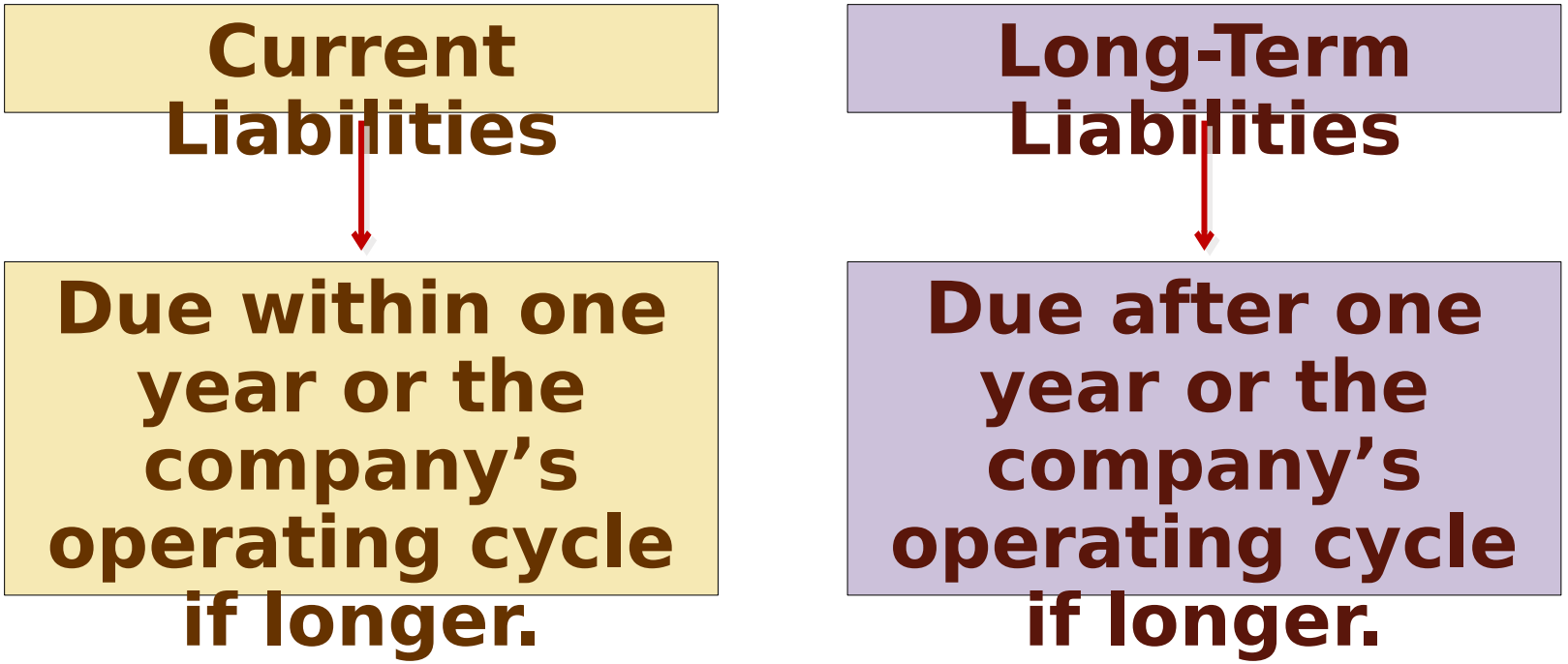
Classifying Liabilities


Current Liabilities
Due within one year or the company's operating cycle if longer.
Long-Term Liabilities
Due after one year or the company's operating cycle if longer.

Learning Objective C1: Describe current and long-term liabilities and their characteristics.

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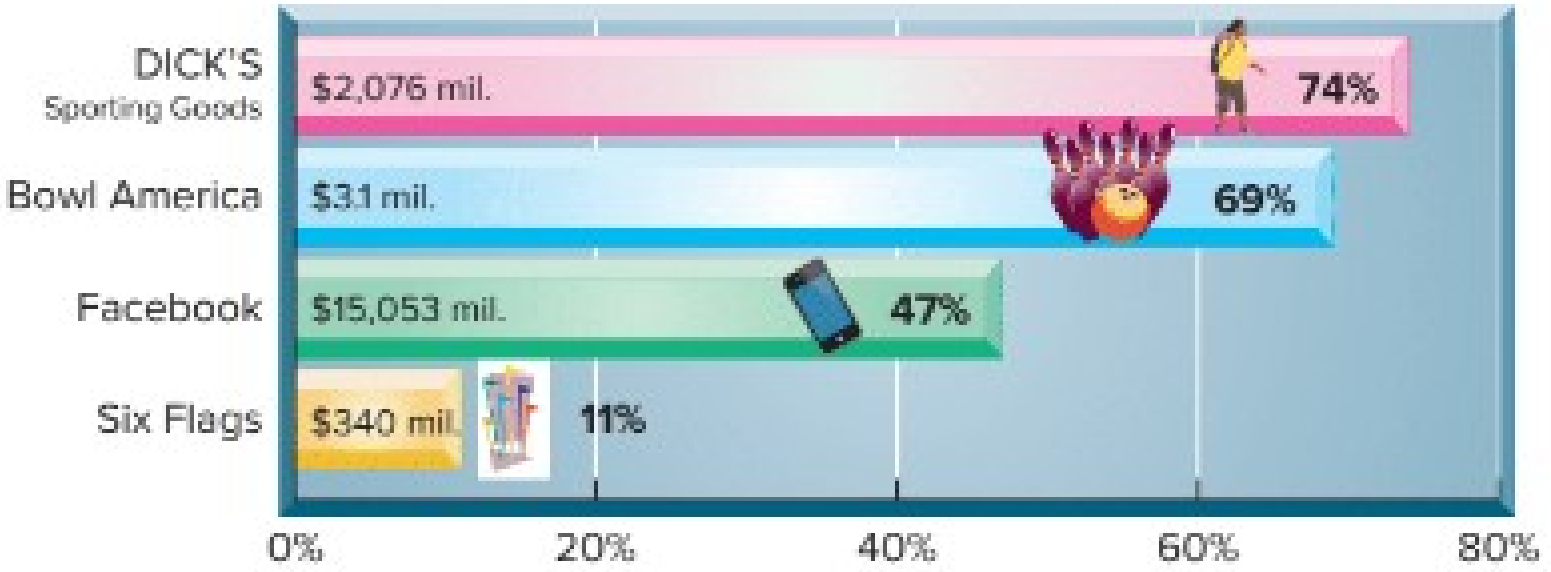
Current and Long-Term Liabilities

Exhibit 11.2



Learning Objective C1: Describe current and long-term liabilities and their characteristics.

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Uncertainty In Liabilities

Uncertainty in Whom to Pay

Uncertainty in When to Pay

Uncertainty in How Much to Pay

Learning Objective C1: Describe current and long-term liabilities and their characteristics.

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Learning Objective C2

Identify and describe known current liabilities.

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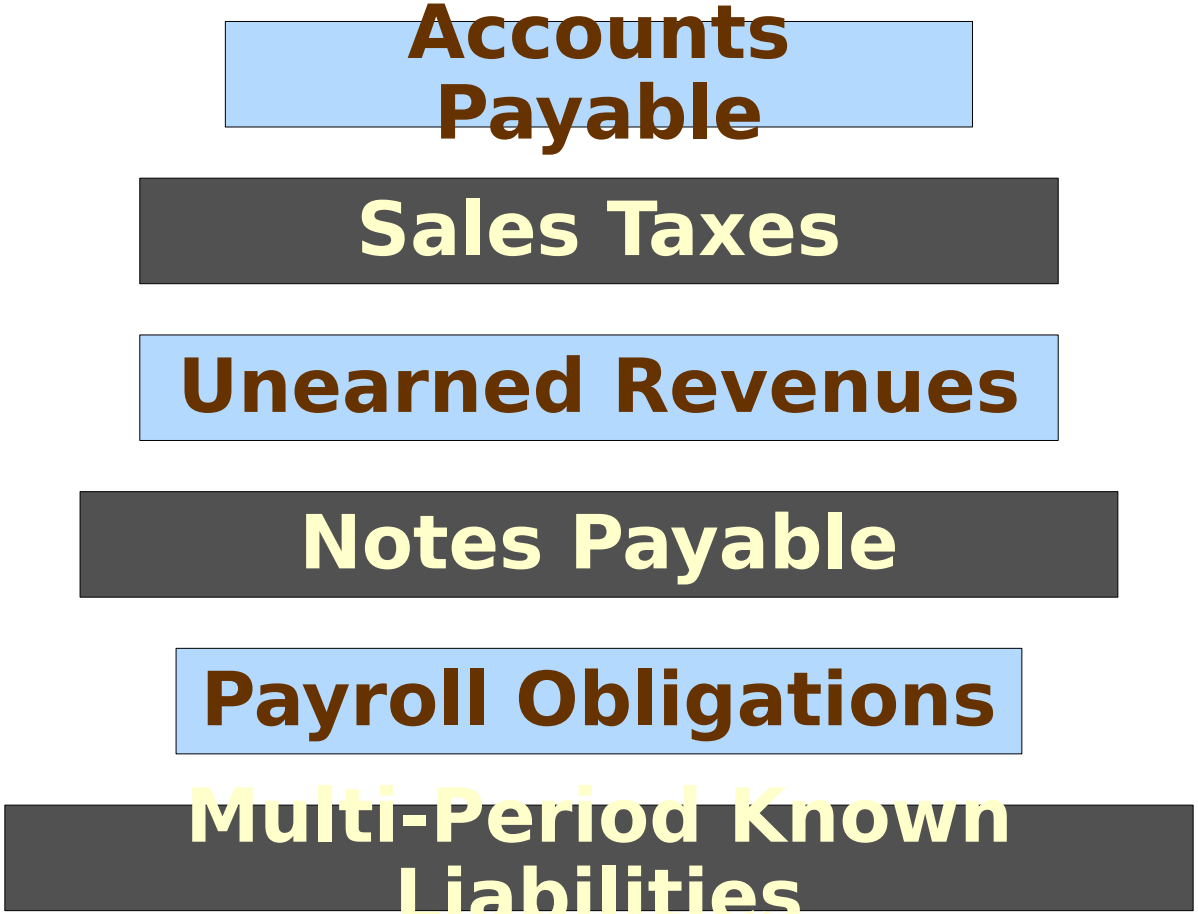
Known Liabilities



Learning Objective C2: Identify and describe known current liabilities.

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Sales Taxes Payable

On August 31, Home Depot sold materials for $6,000 that are subject to a 5% sales tax.

Aug.31	Cash	6,300	
	Sales		6,000
	Sales Taxes Payable ($6,000 × 0.05)		300
	*Record cash sales and 5% sales tax.**		
	*We also Dr. Cost of Sales and Cr. Inventory for cost of sales.		

$6,000 × 5% = $300

Learning Objective C2: Identify and describe known current liabilities.

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Unearned Revenues

On June 30, Selena Gomez sells $900,000 in tickets for three concerts.

June 30	Cash	900,000	
	Unearned Ticket Revenue		900,000
	Record sale of tickets for three concerts.		

On October 31, Selena performs a concert.

Oct. 31	Unearned Ticket Revenue	300,000	
	Ticket Revenue		300,000
	Record concert revenue ($900,000 × 1/3).		

$900,000 × 1/3 = $300,000

Learning Objective C2: Identify and describe known current liabilities.

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Learning Objective P1

Prepare entries to account for short-term notes payable.

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Short-Term Notes Payable

A written promise to pay a specified amount on a stated future date within one year.

Most notes bear interest.

May arise from:

- Overdue account payable
- Borrowing from bank

Learning Objective P1: Prepare entries to account for short-term notes payable.

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Note Given to Extend Credit Period: Date of Replacement

On August 23, Brady Company asks McGraw to accept $100 cash and a 60-day, 12% $500 note to replace its existing $600 Account Payable.

Aug. 23	Accounts Payable—McGraw	600	
	Cash		100
	Notes Payable—McGraw		500
	Sent cash and a note for payment on account		

Learning Objective P1: Prepare entries to account for short-term notes payable.

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Note Given to Extend Credit Period: Date of Payment

On October 22, Brady pays the note plus interest to McGraw.

Oct. 22	Notes Payable—McGraw	500	
	Interest Expense	10	
	Cash		510
	Paid note with interest ($500 × 12% × 60/360)		

Interest expense = $500 × 12% × (60 ÷ 360) = $10

Learning Objective P1: Prepare entries to account for short-term notes payable.

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Note Given to Borrow from Bank

On Sept. 30, a company borrows $2,000 from a bank at 12% interest for 60 days.

Sep. 30	Cash	2,000	
	Notes Payable		2,000
	Borrow $2,000 cash with 60-day, 12%, $2,000 note		

On Nov. 29, the company repays the principal of the note plus interest.

Nov. 29	Notes Payable—McGraw	2,000	
	Interest Expense	40	
	Cash		2,040
	Paid note with interest ($2,000 × 12% ×		

Interest expense = $2,000 × 12% × (60 ÷ 360) = $40

Learning Objective P1: Prepare entries to account for short-term notes payable.

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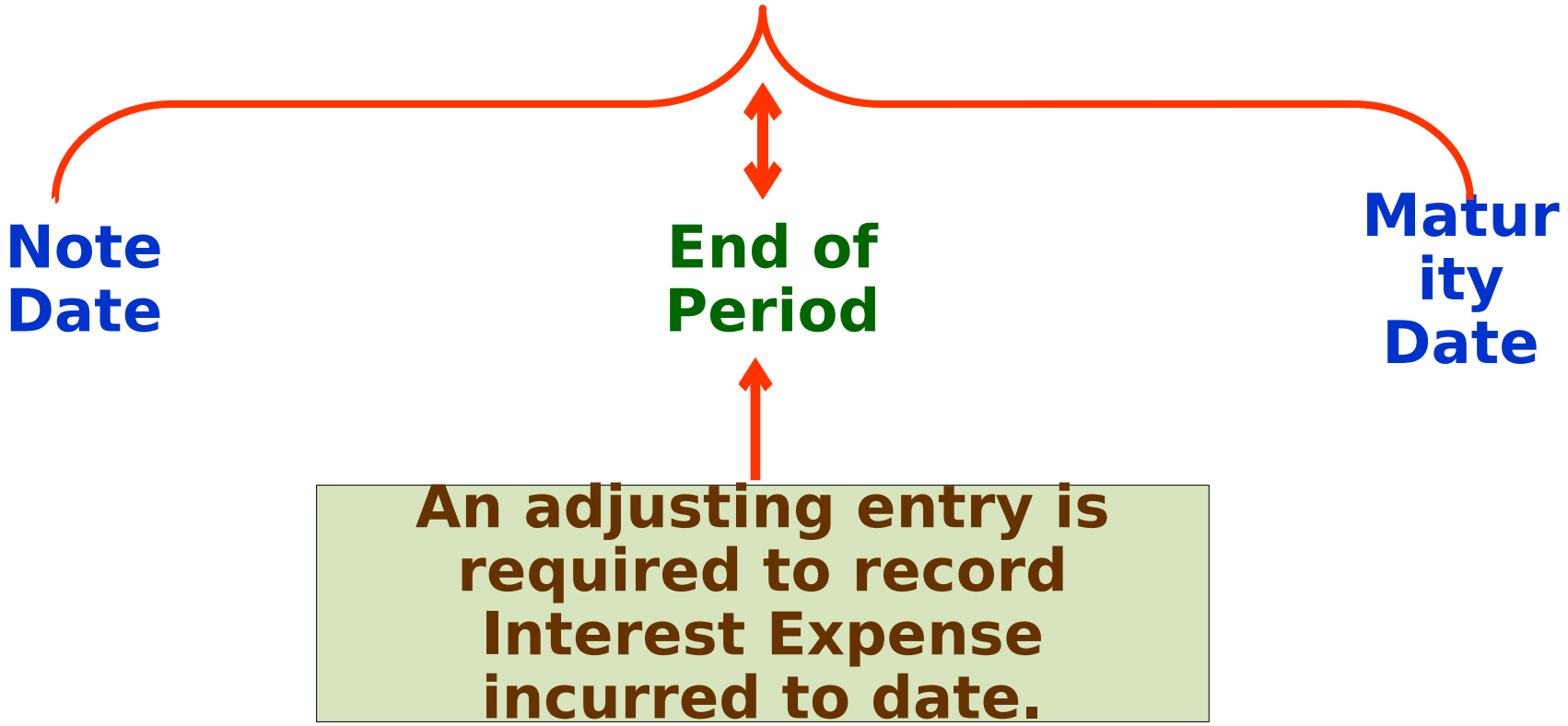
When Note Extends over Two Periods



Learning Objective P1: Prepare entries to account for short-term notes payable.

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End-of-Period Adjustment to Notes

On Dec. 16, 2021, a company borrows $2,000 from a bank at 12% interest for 60 days. An adjusting entry is needed on December 31

Dec. 31, 2021	Interest Expense	10	
	Interest Payable		10
	Record accrued interest ($2,000 × 12% × 15/360)		

On Feb. 14, 2022, the company repays this principal and interest on the note

Feb. 14, 2022	Interest Expense*	30	
	Interest Payable	10	
	Notes Payable	2,000	
	Cash		2,040
	*Paid note with interest. *$2,000 × 12% × 45/360*		

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note

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Learning Objective P2

Compute and record *employee* payroll deductions and liabilities.

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Payroll Liabilities

Payroll liabilities are from salaries and wages, employee benefits, and payroll taxes levied on the employer.

Learning Objective P1: Prepare entries to account for short-term notes payable.

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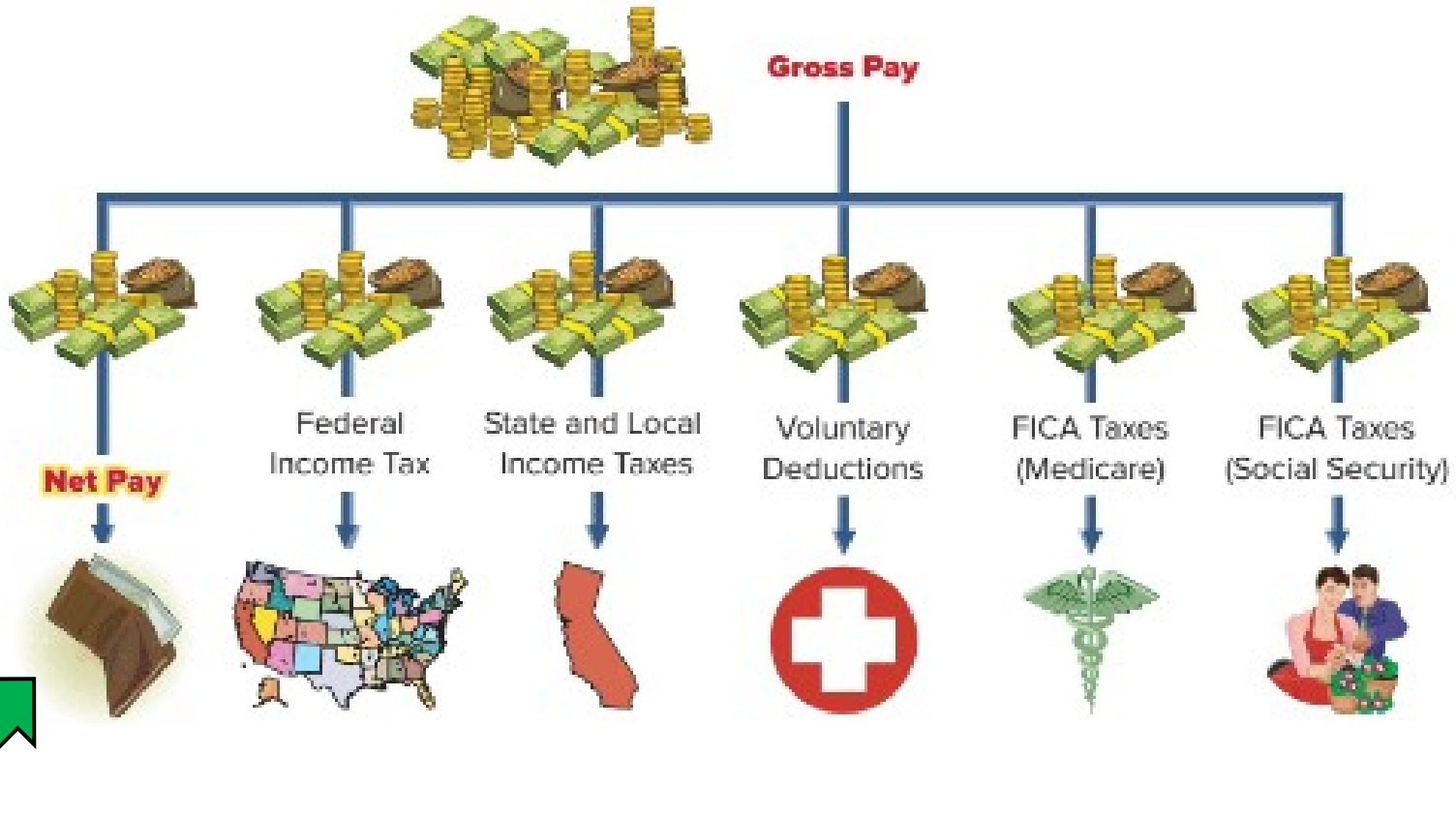
Employee Payroll Deductions

Exhibit 11.3



Learning Objective P2: Compute and record *employee* payroll deductions and liabilities.

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Employee FICA Taxes

Federal Insurance Contributions Act (FICA)

FICA Taxes — Social Security

2020: 6.2% of the first $137,700 earned in the year.

FICA Taxes — Medicare

2020: 1.45% of all wages earned in the year.

Employers must pay withheld taxes to the Internal Revenue Service (IRS).

Learning Objective P2: Compute and record *employee* payroll deductions and liabilities.

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Employee Income Tax

Federal Income Tax

State and Local Income Taxes

Amounts withheld depend on the employee's earnings, tax rates, and number of withholding allowances.

Employers must pay the taxes withheld from employees' gross pay to the appropriate government agency.

Learning Objective P2: Compute and record *employee* payroll deductions and liabilities.

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Employee Voluntary Deductions

Amounts withheld depend on the employee's request.

Examples include charitable giving, medical and life insurance premiums, pension contributions, and union dues.

Employers owe voluntary amounts withheld from employees' gross pay to the designated agency.

Learning Objective P2: Compute and record *employee* payroll deductions and liabilities.

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Recording Employee Payroll

An entry to record payroll expenses and deductions for an employee might look like this:

Jan. 31	Salaries Expense	2,000	
	FICA—Social Security Taxes Payable (6.2%)		124
	FICA—Medicare Taxes Payable (1.45%)		29
	Employee Federal Income Taxes Payable*		213
	Employee Medical Insurance Payable*		85
	Employee Union Dues Payable*		25
	Salaries Payable		1,524
	Record accrued payroll for January.		
	*Amounts taken from employer's accounting records.		

Journal entry to record cash payment:

Feb. 1	Salaries Payable	1,524	
	Cash		1,524
	Record payment of payroll		

Learning Objective P2: Compute and record *employee* payroll deductions and liabilities.

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Learning Objective P3

Compute and record *employer* payroll expenses and liabilities.

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Employer Payroll Taxes

FICA–Social Security Taxes
FICA–Medicare Taxes
Federal and State Unemployment Taxes
* Employers pay amounts equal to that withheld from the employee's gross pay.

* A 0.9% *Additional Medicare Tax* is imposed on the high-income employee for pay usually in excess of $200,000 (this additional tax is *not* imposed on the employer, whereas the others are).

Learning Objective P3: Compute and record *employer* payroll expenses and liabilities.

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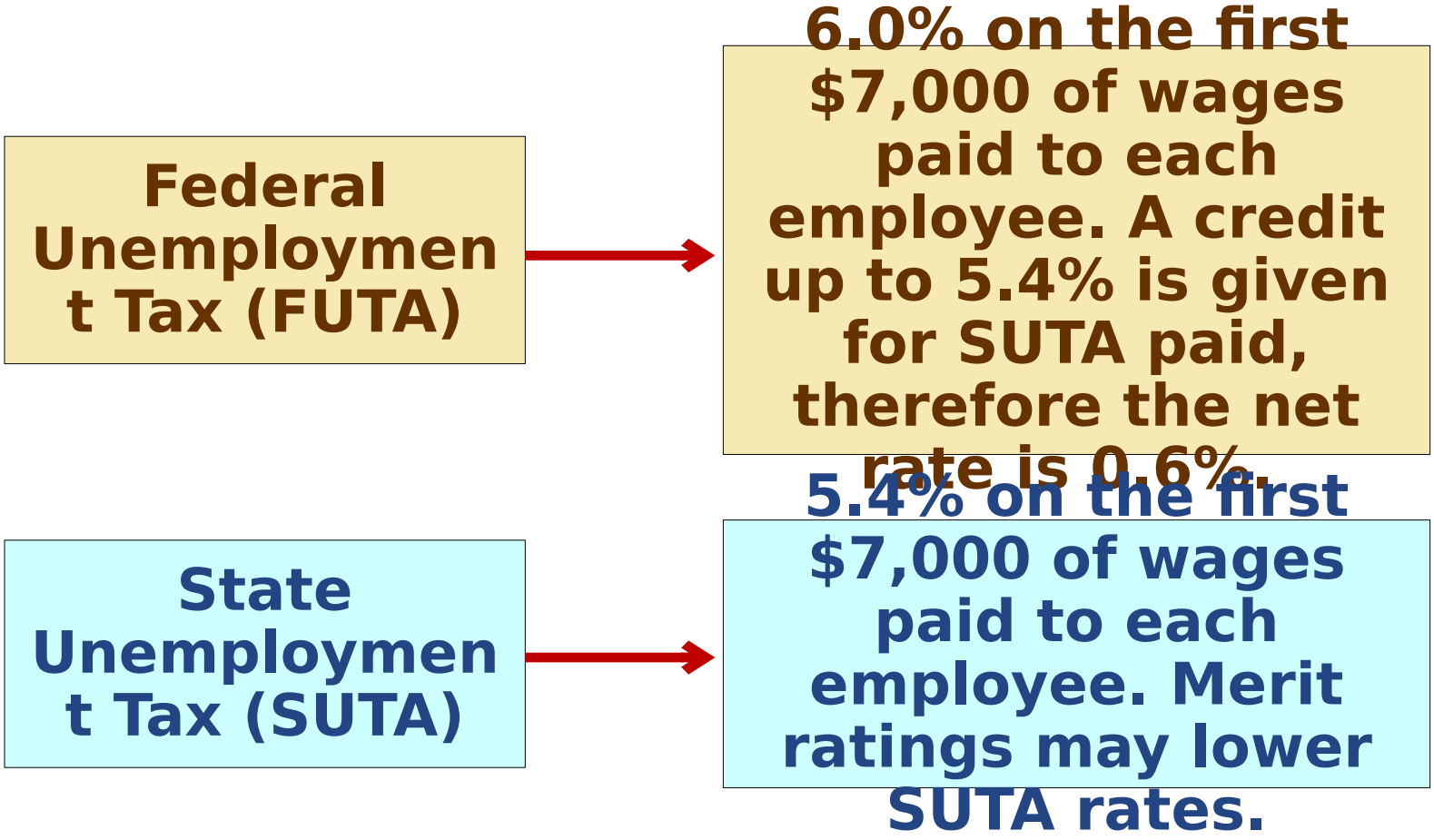
Federal and State Unemployment Taxes


Federal Unemployment Tax (FUTA)
6.0% on the first $7,000 of wages paid to each employee. A credit up to 5.4% is given for SUTA paid, therefore the net rate is 0.6%.
State Unemployment Tax (SUTA)
5.4% on the first $7,000 of wages paid to each employee. Merit ratings may lower SUTA rates.

Learning Objective P3: Compute and record *employer* payroll expenses and liabilities.

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Recording Employer Payroll Taxes

An entry to record the employer payroll taxes for January might look like this.

Jan. 31	Payroll Taxes Expense	273	
	FICA—Social Security Taxes Payable (6.2%)		124
	FICA—Medicare Taxes Payable (1.45%)		29
	State Unemployment Taxes Payable		108
	Federal Unemployment Taxes Payable		12
	Record employer payroll taxes.		

SUTA: $2,000 × 5.4% = $108

FUTA: $2,000 × 0.6% = $12

FICA amounts are the same as that withheld from the employee's gross pay.

Learning Objective P3: Compute and record *employer* payroll expenses and liabilities.

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Internal Control of Payroll

Exhibit 11.4

Four key areas of payroll activities that should be separated and monitored:

Employee Hiring

Duty: Authorize, hire, and fire.
Aim: Keep fake workers off payroll.

Payroll Preparation

Duty: Verify tax rates and payroll amounts.
Aim: Rates updated and amounts accurate.

Timekeeping

Duty: Track and verify time worked.
Aim: Paid for time worked only.

Payroll Payment

Duty: Sign and issue prenumbered checks.
Aim: Checks valid, secured, and correct.

Learning Objective P3: Compute and record *employer* payroll expenses and liabilities.

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Multi-Period Known Liabilities

Includes Unearned Revenues and Notes Payable

Unearned Revenues from magazine subscriptions often cover more than one accounting period. A portion of the earned revenue is recognized each period and the Unearned Revenue account is reduced.

Notes Payable often extend over more than one accounting period. A three-year note would be classified as a current liability for one year and a long-term liability for two years.

Learning Objective P3: Compute and record *employer* payroll expenses and liabilities.

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Learning Objective P4

Account for estimated liabilities, including warranties and bonuses.

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Estimated Liabilities

An estimated liability is a known obligation of an uncertain amount that can be reasonably estimated.

Examples: pensions, health care, vacation pay, and warranties.

Learning Objective P4: Account for estimated liabilities, including warranties and bonuses.

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Health and Pension Benefits

Employer expenses for pensions or medical, dental, life, and disability insurance

Assume an employer agrees to pay an amount for medical insurance equal to $8,000, and contribute an additional 10% of the employees' $120,000 gross salary to a retirement program.

Dec. 31	Employee Benefits Expense	20,000	
	Employee Medical Insurance Payable		8,000
	Employee Retirement Program Payable		12,000
	Record costs of employee benefits.		

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warranties and bonuses.

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Vacation Benefits

Assume an employee earns two weeks of paid vacation each year.

Dec. 31	Vacation Benefits Expense	3,200	
	Vacation Benefits Payable		3,200
	Record vacation benefits accrued.		

When employee takes vacation, following journal entry is recorded:

Jan. 20	Vacation Benefits Payable	400	
	Cash		400
	Record vacation benefits taken.		

Learning Objective P4: Account for estimated liabilities, including warranties and bonuses.

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Bonus Plans

Assume that a bonus of $10,000 will be paid to employees to be shared by all:

Dec. 31	Employee Bonus Expense	10,000	
	Bonus Payable		10,000
	Record expected bonus costs.		

Learning Objective P4: Account for estimated liabilities, including warranties and bonuses.

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Warranty Liabilities: Definition

- Seller's obligation to replace or fix a product (or service) that fails to perform as expected within a specified period.
- Seller reports expected warranty expense in the period when revenue from the sale is reported.
- Seller reports warranty as a liability.

Learning Objective P4: Account for estimated liabilities, including warranties and bonuses.

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Warranty Liabilities: Journal Entries

On Dec. 1, 2021, a dealer sells a car for $16,000 with a maximum one-year or 12,000 mile warranty covering parts. Past experience indicates warranty expenses average 4% of a car's selling price.

Dec. 1	Warranty Expense	640	
	Estimated Warranty Liability		640
	Record estimated warranty expense.		

On Jan. 9, 2022, the customer returns the car for repairs. The dealer replaces parts costing $200.

Jan. 9	Estimated Warranty Liability	200	
	Parts Inventory		200
	Record costs of warranty repairs.		

Learning Objective P4: Account for estimated liabilities, including warranties and bonuses.

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Learning Objective C3

Explain how to account for contingent liabilities.

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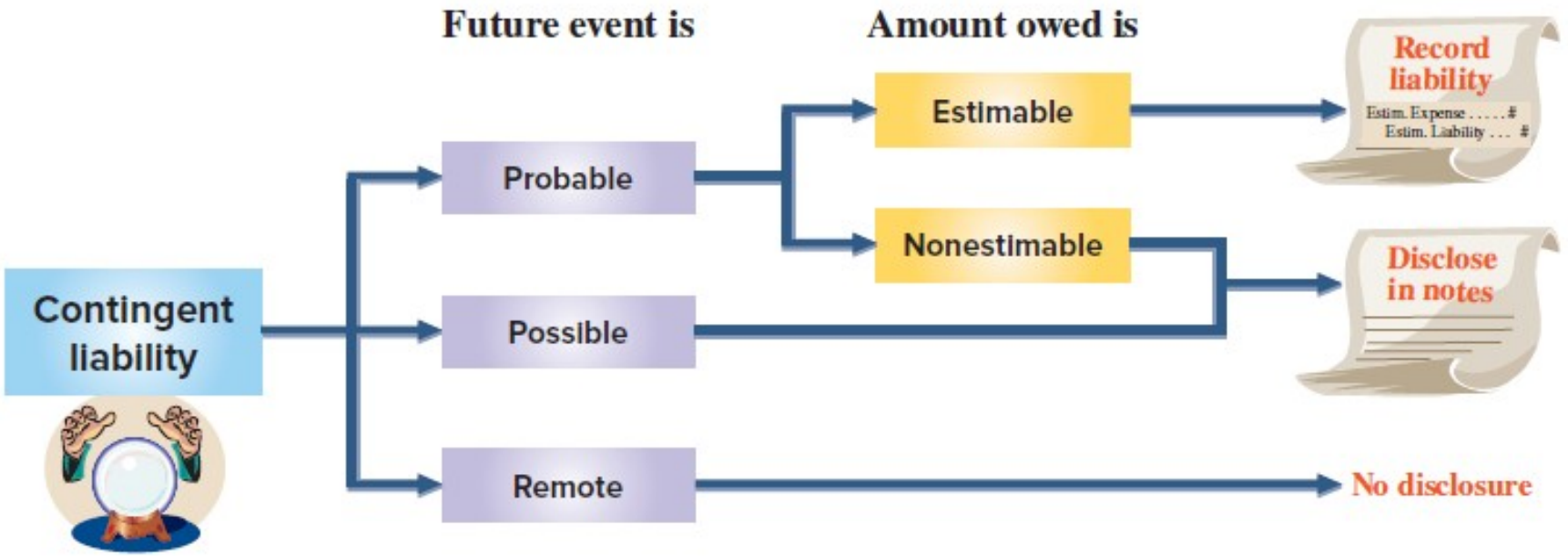
Accounting for Contingent Liabilities

Exhibit 11.5



Learning Objective C3: Explain how to account for contingent liabilities.

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Reasonably Possible Contingent Liabilities

Potential Legal Claims – A potential claim is recorded if the amount can be reasonably estimated and payment for damages is probable. If the potential claim cannot be reasonably estimated but is reasonably

Debt Guarantees – The guarantor usually discloses the guarantee in its financial statement notes. If it is probable that the debtor will default, the guarantor reports the guarantee as a liability.

Other Contingencies – Include environmental damages, possible tax assessments, insurance losses, and government investigations.

Learning Objective 11-3: Explain how to account for contingent liabilities.

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Uncertainties That Are Not Contingencies

Uncertainties – Uncertainties from future events are not contingent liabilities because they are future events and do not arise from past transactions. These are not disclosed.

Learning Objective C3: Explain how a account for contingent liabilities.

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Learning Objective A1

Compute the times interest earned ratio and use it to analyze liabilities.

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Times Interest Earned: Definition

$$\text{Times interest earned} = \frac{\text{Income before interest expense and income taxes}}{\text{Interest expense}}$$

If income before interest and taxes varies greatly from year to year, fixed interest charges can increase the risk that an owner will not earn a positive return and be unable to pay interest charges.

Learning Objective A1: Compute the times interest earned ratio and use it to analyze liabilities.

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Times Interest Earned: Illustration

$ millions	2021	2022 Projections: Sales Increase	2022 Projections: Sales Decrease
Sales	$600	$900	$300
Expenses (75% of sales)	450	675	225
Income before interest	150	225	75
Interest expense (fixed)	60	60	60
Net income	$ 90	$165	$ 15

Exhibit 11.6

$$\text{Times interest earned} = \frac{\text{Income before interest expense and income taxes}}{\text{Interest expense}}$$

Exhibit 11.7

Calculation for Diego for 2020:

$150 / $60 = 2.5 times

Learning Objective A1: Compute the times interest earned ratio and use it to analyze liabilities.

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Learning Objective P5

Appendix 11A

Identify and describe the details of payroll reports, records, and procedures.

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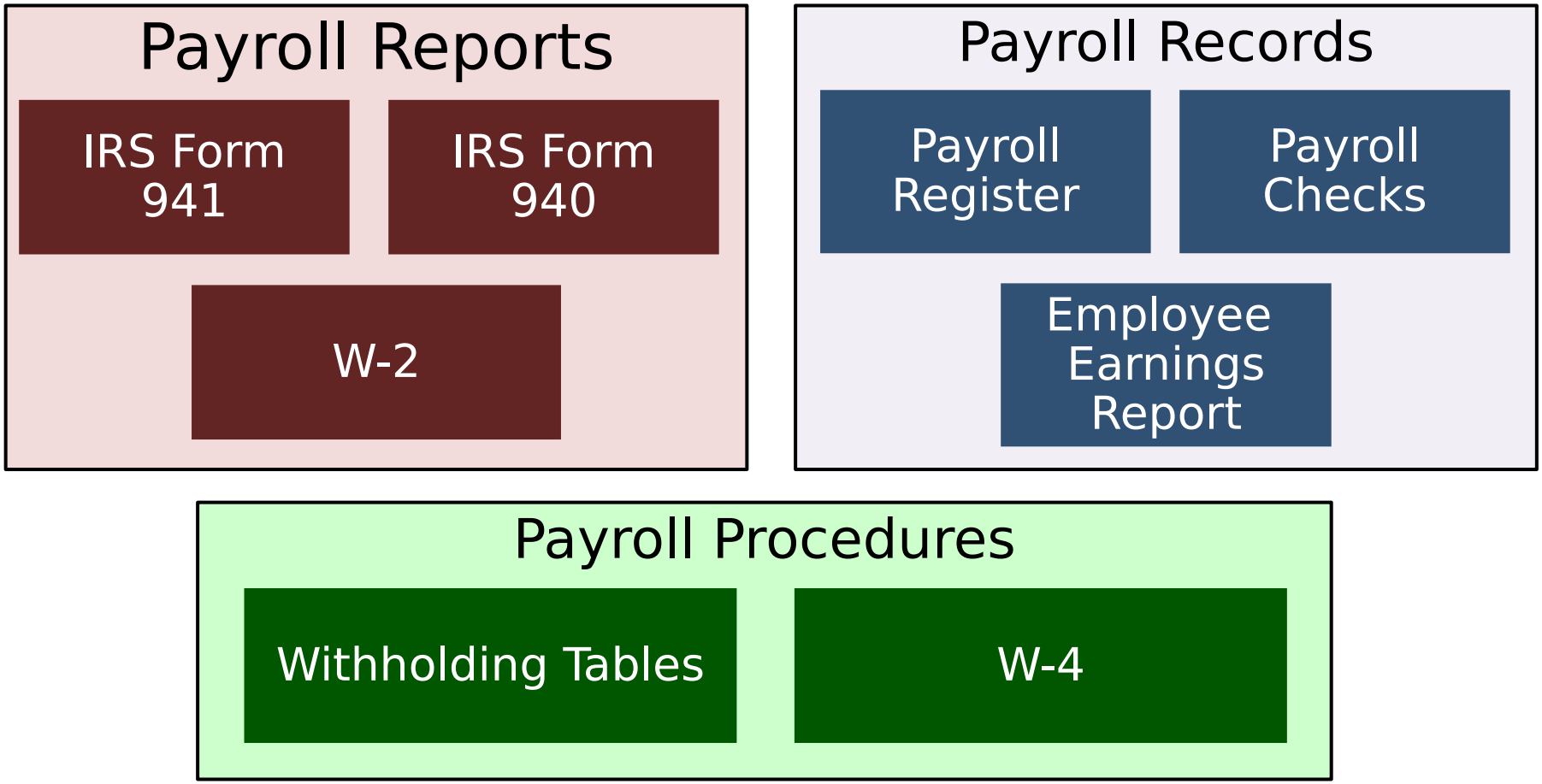
Payroll Reports, Records, and Procedures



Learning Objective P5: Identify and describe the details of payroll reports, records, and procedures.

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Learning Objective P6

Appendix 11B
Account for corporate income taxes.

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Corporate Income Taxes

Corporations must pay taxes on income.
Adjusting entry for income tax liabilities:

Jan. 31	Income Taxes Expense	12,100	
	Income Taxes Payable		12,100
	Accrue January income taxes.		

Apr. 10	Income Taxes Payable	30,000	
	Cash		30,000
	Paid estimated first-quarter income taxes.		

Assume $25,000 of income taxes expense; $21,000 currently due and $4,000 deferred:

Dec. 31	Income Taxes Expense	25,000	
	Income Taxes Payable		21,000
	Deferred Income Tax Liability		4,000
	Record tax expense and deferred tax liability		

Learning Objective P6: Account for corporate income taxes.

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End of Chapter 11

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